

A Reflection on *Company Financial Reporting* After 10 Years

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ABSTRACT In this article we review developments in the regulation of financial reporting in the Netherlands during the last ten years. The main theme is the Dutch response to the increasingly international nature of financial reporting. We argue that this response has on the whole been more reactive than warranted by the circumstances. We also welcome recent moves towards a stricter system of compliance monitoring and briefly discuss a number of other themes including auditor independence.

1 Introduction

In our book, *Company Financial Reporting: A Historical and Comparative Study of the Dutch Regulatory Process* (North-Holland, 1992), we were critical of certain conditions in which financial reporting was regulated and practiced, and we proposed several reforms. The editorial board of *Maandblad voor Accountancy en Bedrijfseconomie* kindly invited us to review and discuss the key points in the chapter containing our conclusions and recommendations in the light of developments since the end of 1991, when we completed our research and writing. This article constitutes our review and was completed in July 2002. It should be understood that this article is not an attempt to extend our original research into the 1990s. To do so would have required a far greater investment of effort in, for instance, collecting opinions through interviews than was called

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for by the article envisaged by the editor of this journal. What we attempt to do in this article is to give our interpretation of the salient facts as they presented themselves to us at the time of writing. Given the limited scope of this article, we obviously had to present our arguments succinctly. We realize that, to those involved in the complex policy-making underlying these events, our review may occasionally appear unsubtle or wide of the mark. In such cases, we hope that our review will be read as an invitation to bring alternative views in the open. This article is structured as follows. Sections 2 and 3 contain the core of the article, treating the standard-setting process and the mechanism of ensuring compliance with standards, respectively. Section 4 reviews developments in the environment of financial reporting, including the financial markets, the financial press and academia. Section 5 follows up on two specific observations made in our book. We end in section 6 with conclusions.

2 Setting the Standards

A major development since 1991 is that the central focus of standard-setting has irreversibly shifted from the national to the international level. Because of this development, the Raad voor de Jaarverslaggeving (RJ), like other European standard setters, very likely finds itself in the twilight of its tenure, except to the extent that it will need to provide guidance to non-listed companies that are not required by Dutch law to comply with International Financial Reporting Standards (IFRS)¹. As we will argue later, the RJ, as well as the Koninklijk Nederlands Instituut van Registeraccountants (Royal NIVRA), did not prepare themselves to play leadership roles in the international standard-setting process.

2.1 Structure of the RJ

The RJ is the body most responsible in the Netherlands for contributing to the improvement of finan-

cial reporting practice, and it will presumably continue to be important for non-listed companies following 2005². Its basic structure has not changed since the early 1990s, i.e., three delegations of four members each from preparers, auditors, and users, plus a chairman. Eight of the twelve current members (there is one vacancy) are RAs, compared to 12 out of 13 at the end of 1991. Very recently, a representative of NOvAA has been added to the auditors delegation, and we understand that a representative of small and medium-sized companies, presumably not an RA, will fill the remaining vacancy in the preparers delegation. Hence, the diminishing preponderance of RAs on the board, although a crude measure by itself, does suggest that a wider diversity of viewpoints is being represented.

Historically, the auditors and users delegations played constructive roles in the advancement of the work of the RJ, while the preparers delegation was more of a constraining force. Therefore, the composition of the auditors and users delegations was critical to its success. In our book (p. 377), we recommended that 'At least several genuine representatives of financial statement users should form part of the [users] delegation'. In 1991, only one of the four members of the users delegation could be described as a user. At the present time, the delegation is chaired by a partner of a small audit firm (that has close links with the labor movement, an important user), and its other three members are two academics and a financial analyst. It is still questionable whether the users delegation is appropriately constituted, as the RJ has never had a representative of either private or institutional investors. From 2005 onward, when the RJ will operate mainly for the benefit of non-listed companies, the role of a users delegation may not be as important as it is now, although bankers will constitute an important class of users. We will discuss the auditors delegation in the section on the NIVRA.

In our book, we argued that the decision-making process in the RJ was too slow (pp. 373-374). We have noticed an acceleration in the RJ's output process of issuing guidelines since 1991 but mainly for the reason that most of its time was devoted to adapting the International Accounting Standards Committee's (IASC's) standards to the Netherlands rather than engaging in the more consequential work of developing original standards. It did, however, develop its own 'industry standards' in such fields as insurance, health care and housing cooperatives.

Obviously, these tasks would have claimed most if not all of the RJ's resources. But the important point is that the RJ, as far as we can see, never outgrew the

consensus culture that was ingrained in its structure from the outset. Therefore, as we envisaged in our book (pp. 376, 383), even if the RJ had had resources to spare we doubt that its decision-making process would have allowed it to produce the kind of innovative standards on emerging issues that would have established the RJ as an important standard setter internationally.

2.2 Role of the NIVRA

We also argued (pp. 380-381) that the NIVRA should play more of a leadership role in the improvement of accounting in the Netherlands. But the time for developing this role has probably passed, because, as we stated earlier, international accounting standards have overtaken national standards in importance. The question then becomes whether the NIVRA is well-positioned to play an international role. Unfortunately, the NIVRA does not have the international standing that it once had, at least in the realm of financial reporting. As recently as the 1970s, the NIVRA was still in its mode of aggressively advocating the use of current cost accounting, and in addition it participated actively in international accounting congresses, and, of course, as a founding member of the IASC it formed one of the delegations to the IASC's board. The international influence of the NIVRA was then at its zenith. Since then, the fervor in the Netherlands for current cost accounting has almost disappeared, and the NIVRA failed to find another issue that would reestablish its international comparative advantage. In 2000/01, when the IASC board was restructured as the IASB, national seats were abolished but to a certain extent replaced by giving designated board members a liaison role with eight national standard setters. Of the former board member countries, only the Netherlands and Mexico were not accorded a liaison. Nor did any members of the new board come from the Netherlands or Mexico. The Dutch are well represented on the Technical Expert Group (TEG) of European Financial Reporting Advisory Group (EFRAG). The chairman of the TEG is Johan van Helleman, and one of the other ten members, Hans Leeuwerik, is also a Dutchman. Another Dutchman, Leo van der Tas, has been a member of the IASC's Standing Interpretations Committee (now the IASB's International Financial Reporting Interpretations Committee) since its inception in 1996. However, these positions are occupied on a personal basis and therefore do not necessarily represent a strong international position of the NIVRA. We would argue that, in the present

circumstances, the most convincing proof of the NIVRA's continued international standing would be a liaison relationship between the Netherlands and the restructured IASB. Formally, of course, the liaison would be with the Dutch standard setter, the RJ. Yet because the NIVRA is deeply involved in the work of the RJ through its *Commissie Jaarverslaggeving*, the existence of a liaison relationship would clearly reflect the significance of the NIVRA itself. In fact, such a liaison relationship has not been established³. We can offer several reasons for this missed opportunity, some largely beyond the NIVRA's control, but others within.

Prior to the mid 1980s, the Dutch accountancy profession was almost alone on the European continent in focusing on the provision of financial information to the capital market. The profession in virtually all of the other countries on the continent fixated on reporting to the income tax authority. Most of the major companies in those countries were financed by bank loans, or via family or state ownership, and the countries' capital markets were less than vibrant. Accounting leaders in the United States and the United Kingdom, as well as those in Canada and Australia (all members of G4+1⁴), believed that, of the accountancy bodies on the continent, the NIVRA would be in the best position to understand the ideology and practice of investor-oriented accounting. Leading Dutch accounting practitioners were also well versed in the U.S. and U.K. accounting literature. Thus, the Dutch, being kindred spirits, were in demand as an indispensable European partner in overseas standard-setting circles. By the end of the 1990s, however, most of the EU countries on the continent had philosophically signed on to investor-oriented accounting, and the Dutch were no longer prized as the bridge between the Anglo-American countries and most of the countries of the European continent. During the formation of the IASB, therefore, the Netherlands was passed over in favor of larger countries, such as France and Germany, as liaison partners. In this sense, the Dutch became marginalized⁵.

In contrast, New Zealand, whose accountancy body was not a permanent member of the IASC board, was nonetheless added to the liaison list, after its standard setter had already become a member of the G4+1 during the 1990s. This shows that a small country can still play a role in international standard setting, and we believe that appropriate or more timely action on the part of the NIVRA might have done much to place the Netherlands in a similar position.

The authors have learned from several sources that, in 1992, the RJ was informally approached by several

members of Anglo-American standard setters about joining with them in a study group that eventually became the G4+1. The informal response from the RJ was that it did not then possess sufficient resources to join in the work of the study group. Today, the budget of the RJ, at about € 425,000, is approximately the same as that of New Zealand's Financial Reporting Standards Board, at about NZ\$ 865,000, or € 415,000. At first sight, therefore, there is no reason to assume that the RJ is insufficiently funded. Yet New Zealand's standard setter cooperates closely with the Australian Accounting Standards Board, whose budget of A\$ 3.1 million (€ 1.8 million) is significantly larger. Other bodies participating in the G4+1 also had budgets far exceeding that of the RJ⁶. Therefore, setting aside the option of teaming up with another, better funded standard setter, the NIVRA, as well as leading Dutch accounting firms, would have had to provide the RJ with more extensive resources for the RJ to have had a chance to become an effective standard setter, whose output would attract attention at the international level. In fact, in the late 1990s the NIVRA did attempt to make up some of the lost ground by participating actively in the E5+2 study group⁷ and sponsoring its discussion paper on 'Management's Analysis of the Business'. However, E5+2 proved to be short-lived, leaving the NIVRA to find other ways to regain its international position. As it is, the Netherlands has become an importer of accounting standards and is no longer a major actor on the world stage.

3 Securing Compliance with Standards

3.1 General trends

In our book, we placed considerable importance on the need for an effective organ to secure compliance with financial reporting norms. We recommended either an adaptation of the Financial Reporting Review Panel in the United Kingdom, or an expansion of the authority delegated to the *Procureur Generaal* (pp. 378-379). The importance of compliance has not diminished. The major unanswered question in this regard is how EU countries, most of which, like the Netherlands, do not have a history of strong enforcement of accounting standards, will enforce compliance with IFRS. Only the United States, Canada, the United Kingdom and Australia have established effective programs for enforcing compliance with accounting standards, although even these programs may offer less than what is expected by the capital market. In the Netherlands, the *Ondernemingskamer* (OK), which was established in

1971 as a judicial organ, was effective in the 1970s and 1980s because of the intervention of Pieter Lakeman and his SOBI in bringing lawsuits. But after about 1987, except for several further interventions by Lakeman in the late 1990s and early 2000s, the lack of interest on his part meant the OK was no longer a force in enforcing compliance. To be sure, comparatively little evidence has been adduced to suggest a general problem with lack of compliance with Dutch accounting law or the RJ's guidelines. There have been no financial scandals in the Netherlands in which, as with Enron and WorldCom in the United States, deceptive financial reporting has dominated the headlines. Yet, in the case of Baan the quality of financial reporting was nonetheless called into question in the press. The NIVRA's series of annual surveys of financial reporting, *Het Jaar Verslagen*, lists several examples of guidelines where full compliance was not, or was only tardily, achieved. Moreover, the flexibility and judgmental character of the law and many guidelines makes it possible for doubts to be aired about the quality of financial reporting even though few formal breaches of the rules can be pointed out. Given that the IASB's standards promise to be much more restrictive, we suspect that the number of instances of alleged lack of compliance in the future may well increase, unless a more rigorous system of enforcing compliance becomes effective (see below).

It was only in 2000 that the NIVRA issued a new edition of the *Richtlijnen Accountantscontrole* in which it finally got round to announcing that, for financial statements to be regarded as in accordance with 'accounting principles generally accepted in the Netherlands', they must comply with the bold-faced passages in the guidelines. This is a step that the NIVRA contemplated taking as long ago as 1983 but postponed because of controversy in the profession over the scope of its authority.

As will be brought out below, the Ministries of Justice, Finance and Economic Affairs have announced their intention to set up a financial reporting section for listed companies in the public sector Stichting Toezicht Effectenverkeer, which was retitled Autoriteit Financiële Markten in March 2002.

This very retitling of the Stichting as an Autoriteit is indicative of a trend that we anticipated on pp. 381-382 from the *overleg*-culture to a decision-culture. The earlier consensus, or polder, culture in the Netherlands, by which an elaborate and lengthy process of consultation among all interested parties was necessary before even the most carefully hedged decisions might be taken, for example in fashioning the accounting guidelines, has gradually evolved toward a

culture in which greater authority is vested in decision-making bodies to act without necessarily being responsive to the advice received. Furthermore, the STE was set up in the late 1980s to oversee the Vereniging voor de Effectenhandel⁸, which was the association of securities traders that governed the Amsterdam Stock Exchange. In this respect, the long tradition of encouraging self-regulation in the Netherlands has gradually been supplanted by regulation by the public sector. A further example is the imminent move by the Government to impose external supervision on auditors, as a result of which some of the responsibility for overseeing the legal audit would be removed from the NIVRA. Both of these developments – the movement toward a decision-culture and toward external regulation – are, in our view, interrelated. In our book (pp. 378-383), we argued that the former would be desirable and that some form of strengthened regulation – although not necessarily in the public sector – should be encouraged. But the benefits of a decision culture might be lost if it were to degenerate into a lobbying culture.

For its part, the Autoriteit Financiële Markten is cooperating in the work of the Committee of European Securities Regulators, which, among other things, plans to stimulate the development and installation of effective compliance systems for financial reporting in the EU Member States.

3.2 New System for the Netherlands

On 30 May 2002, the Justice, Finance and Economic Affairs Ministries jointly informed Parliament of the outline of their proposed structure for securing compliance with IFRS in the Netherlands⁹. That all three Ministries collaborated in the development of this proposal meets one of the criticisms in our book, namely, that there was a need for the policies of the three Ministries – overseeing company financial reporting, the capital market, and the accountancy profession – to be co-ordinated 'in the interests of Dutch society' (p. 378).

The report properly calls for the 'passive' supervision by the OK to be supplemented by 'active' supervision by an independent public body, the Autoriteit Financiële Markten. The supervision would encompass all of the external financial reporting (annual, half yearly and quarterly reports) by companies domiciled in the Netherlands with securities listed on EU stock markets. The supervisor would be supported by an annual budget of € 2.5 million for this purpose, which implies the creation of a sizable staff of experts. The supervisor would act on its own initiative and

would possess the authority to require companies to redress 'material shortcomings' via restatements or supplementary information. The supervisor cannot set new standards, but it may, in limited circumstances, issue its own interpretations of IFRS. Whenever possible, however, it is expected to refer such issues to IFRIC. Its freedom to act in this regard is further circumscribed by a requirement to act in concert with other supervisory bodies in Europe. Whether this will leave it any substantial powers of interpretation remains to be seen.

We believe that this proposal represents an important step toward regulating financial reporting compliance, as it fulfills the recommendations we made in our book on pp. 378-379. The proposed supervisory structure appears to fall somewhere between that of the Financial Reporting Review Panel in the United Kingdom and that of the Securities and Exchange Commission in the United States¹⁰. The Review Panel may act on referrals, not on its own initiative (which is a weakness), and its initial action is to try to persuade the company to restate its financial report in order to give 'a true and fair view'. Failing that, the Panel could bring an action against the company in civil court (which so far it has not done). The SEC not only has authority to require companies to restate their financial reports, but it is also empowered to set accounting standards. Although it has historically looked to the Financial Accounting Standards Board for standard setting, the SEC has, on numerous occasions, modified U.S. Generally Accepted Accounting Principles (GAAP) on its own initiative in order to promote 'full and fair disclosure' and to prevent financial reporting abuses.

One possible concern is that the report does not refer to 'getrouw beeld', as set out in Dutch company law, as the overriding arbiter of proper financial reporting practice. The supervisor is to do no more than assure itself that companies have adhered to 'proper and consistent application of international reporting standards, and [that the financial statements are] compatible with the rest of the contents of the annual report to shareholders'¹¹. Yet the fact that the aforementioned EU regulation charges the European Commission to accept only those IFRS 'whose application results in a true and fair view of the financial position and performance of an enterprise' (paragraph 9 in the preamble), seems to imply that a Member Country's supervisor need not again address this issue. IFRS itself provide for a 'fair presentation' override only in 'the extremely rare circumstances when management concludes that compliance with a requirement in a Standard would be misleading' (IAS 1).

Complementing this proposed new structure applicable to listed companies, there should be a systematic effort to secure compliance with the financial reporting norms applicable to non-listed companies that are not required to adopt IFRS. The NIVRA should be prepared to play the central role in this sphere. The system of peer reviews (collegiale toetsing) in use since 1997 does, among other things, address this issue. However, the primary focus of peer reviews is on the effectiveness of internal systems of quality control, not on compliance with financial reporting standards. The NIVRA also regularly surveys the quality of financial statements filed with the Registrar of Companies (Handelsregister), but this does not, apparently, lead to consultation with the auditors involved on an individual basis.

4 Other issues

The shareholder culture has risen to greater prominence in the last ten years. According to the Centraal Bureau voor de Statistiek, the percentage of households that own company shares has risen from 8.9% in 1993 to 17.2% in 1999. At the same time, there has been a heightened interest in the quality of corporate governance, as evidenced by the private-sector Peters report, *Corporate Governance in the Netherlands*, issued in 1997. Yet the insular character of company supervisory boards, which are empowered to select their own members, continues to constitute a barrier to hostile takeovers. In our book, we raised the prospect of the eventual approval of the 13th Directive on company takeovers. This event has yet to happen. But even though the Directive was not approved in its first submission to the European Parliament, it is on course for resubmission following modifications. Once the Directive is approved, thus lowering the barriers to contested takeovers in the EU, it is likely that companies will, as in the United States and United Kingdom, come under increased pressure to report favorably on earnings, which in turn will underscore the importance of an alert and rigorous supervisor to enforce compliance with accounting standards.

Since 1991, the financial press has taken a more active interest in financial reporting, including especially *Het Financieele Dagblad*. Both *De Volkskrant* and *NRC Handelsblad* have expanded their business sections to devote more coverage to financial reporting, perhaps as a consequence of the steady rise in the stock market in the 1990s. Furthermore, in some parts of the financial press one sees more criticism of company financial reporting than before. Also since 1991, there has been a significant increase in the number of

Dutch companies whose shares are publicly traded in New York, and during the 1990s there has been an increasing awareness among investors and in the financial press of the reporting standards of U.S. GAAP, which were, at least before Enron, regarded as more demanding. In March 2002, Philips, whose shares had been traded in New York since 1953, announced the adoption of U.S. GAAP in its primary financial statements, thus joining a number of other prominent European companies (e.g., DaimlerChrysler, Siemens, Deutsche Bank).

In regard to Dutch accounting academe, we noted in our book (p. 377) the lack of an independent voice and a preoccupation with practical as opposed to more fundamental research, and we linked both to the preponderance of part-time academics. The number of full-time professors has indeed increased somewhat, and the number of Dutch contributions to international research journals has certainly grown, albeit from a very low base. While these developments are to be welcomed, there is still much to be done to establish an international reputation for academic research emanating from the Netherlands. At the same time, it is important that a heightened focus on international research does not, as has occurred in some other countries, diminish the interest of academics in the issues and problems in accounting policy and practice. Indeed, one sign of a loosening of ties between practice and academe was the discontinuation in 2000 of the annual *fma-Congres*, the only event at which accounting academics and practitioners convened in order to give and hear papers.

Another is the decision to dismantle the Limperg Instituut, a research center sponsored by the accountancy profession and several universities that never realized the high expectations set for it.

5 Two Observations

Two of the observations in our book resonate well today. First, we raised the specter that European companies would complain of 'competitive disadvantage' (p. 379) if the financial reporting requirements in one country were more rigorous in their country than in others. In fact, one only need read the letters posted by the IASB on the subject of share-based payments to see that some 16 major European multinationals, including four from the Netherlands, have claimed competitive disadvantage if the IASB were to require the expensing of the value of employee stock options without a corresponding change occurring in U.S. GAAP. This claim has a basis in paragraph 15 in the

preamble to the aforementioned European Union Regulation 1606/2002. In that paragraph, it was stated that 'the [European] Commission should take into account the importance of avoiding competitive disadvantages for European companies operating in the global marketplace'. Consequently, our perception that competitive advantage may be 'a pretext to resist any new reporting requirements' (p. 379), while perhaps no longer an issue as between European countries, has nonetheless become a major issue in the setting of international accounting standards to the extent that (1) the Americans resist the adoption of some of those standards or (2) the IASB is under pressure to converge with U.S. GAAP.

Second, we wrote: 'Especially at a time when, as in a number of countries, the increasingly commercial environment in audit firms threatens the auditor's steadfast dedication to principle in discussions with clients, the organization of auditors must invigorate the commitment to independence and integrity on the part of the audit profession' (p. 381). To be sure, major accounting and auditing questions have been raised in the press in such notorious cases as Lernout & Hauspie, Cendant, Sunbeam, Waste Management, Enron, Comroad, Xerox and WorldCom. While these cases did not occur in the Netherlands, they nonetheless sounded an alarm to auditors, accountancy bodies and financial market regulators around the world. In June of this year, the NIVRA issued further guidance on auditors' independence, based on a recent European Commission statement of recommended principles. To its credit, the NIVRA, in a joint effort with the NOvAA, was the first national organization to act on the Commission's recommendations. Yet we would argue that this still leaves the Netherlands as an importer rather than an exporter of ideas. Moreover, by deferring its action until the signal was given by the European Commission, the NIVRA made itself vulnerable to the charge of not taking decisive action while the issue of independence was repeatedly, and critically, raised in the Dutch press during the second half of the 1990s.

6 Conclusion

We are pleased that several of the recommendations in our book have become reality, although we do not claim the credit. The three Ministries are co-ordinating their mandates, a more effective system for enforcing compliance with accounting norms has been advanced by the Government, the RJ has accelerated its production of guidelines, and there is a more

lively discussion of financial reporting in the press. While the NIVRA played a role in some of these developments, any leadership by it in this sphere has not been evident to the public. In our book, we wrote, 'the NIVRA should perform a clear and understandable function as a forceful intermediary between the users and preparers of financial information. The role must be visible to outsiders, else its effect could be diluted' (p. 381). Our impression is that the NIVRA has been very implicit in its approach. The performance of a country's major accountancy body should be more transparent.

While we are encouraged by recent steps taken toward establishing an administrative authority for enforcing compliance with IFRS in the Netherlands, we are disappointed that the Netherlands is playing less of a role in the work of the IASB than it did in that of the IASC. While we realize that the scope for the Netherlands' role in international standard setting is narrower than before, we believe that, with inspired leadership, coupled with matching imagination and resources, a more significant contribution by the Dutch accounting profession and standard setter could yet be achieved.

Recent developments have heightened the urgency of a further point made in our book, namely, that 'the organization of auditors must invigorate the commitment to independence and integrity on the part of the audit profession' (p. 381). The private sector should demonstrate leadership in this field, and promptly, else the Government will move even further than it has so far to fill the void. ■

Noten

- 1 In 2001, the IASB changed International Accounting Standards to International Financial Reporting Standards.
- 2 In July 2002, the European Union promulgated Regulation 1606/2002 requiring all listed companies to comply with IFRS by 2005 (or by 2007 for companies already listed in the United States and that already applied US GAAP in financial years starting before July 2002).
- 3 Board member Geoffry Whittington does function as a liaison with the Netherlands and the Nordic countries, but this is intended as a 'second tier' liaison, in contrast with his primary liaison with the UK Accounting Standards Board.
- 4 The founding members of the G4+1, established in 1994, were the standard setters in the United States, Canada, the United Kingdom and Australia. New Zealand was added several years later. The '+1' was the IASC.
- 5 To be sure, both France and Germany were founding members of the IASC, yet prior to the 1990s the accounting and financial authorities in France and Germany had taken few steps to encourage the use of the IASC's standards in their respective countries.
- 6 The U.K. Accounting Standards Board's 2001 budget was £ 2.9 million

(€ 4.5 million), and the Canadian Accounting Standards Board had a 2001 budget of C\$ 2.4 million (€ 1.5 million).

- 7 The European Accounting Study Group (E5+2) was formed in 1997. Its membership included the five European delegations to the IASC Board, i.e., France, Germany, the Netherlands, the Nordic countries and the United Kingdom, joined by representatives of their national standard-setters, the European Commission and FEE.
- 8 The Amsterdam Stock Exchange is now governed by Euronext, a for-profit, private sector body that also controls the Paris, Brussels and Lisbon exchanges.
- 9 'Kabinetstandpunt toezicht op externe financiële verslaggeving beursgenoteerde ondernemingen' (28 386 nr 1, 30 May 2002).
- 10 Until it becomes known precisely what powers of enforcement the Autoriteit will possess, and what possibilities companies may have to appeal against its decisions, the comparison with these two overseas bodies remains somewhat unclear.
- 11 We presuppose that this requirement of compatibility would apply also to half yearly and quarterly reports.